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Supreme Court of the United States

OCTOBER TERM, 1963

MOHAWK LIQUEUR CORPORATION, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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OCTOBER TERM, 1963

No.

MOHAWK LIQUEUR CORPORATION, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, entered on October 21, 1963, reversing a judgment in favor of petitioner on an action for refund of federal income taxes entered by the United States District Court for the Eastern District of Michigan.

OPINIONS BELOW

The opinion of the court of appeals (R. 43), dated October 21, 1963, is reported at 324 F.2d 241. It is reprinted in Appendix B to this petition (pp. 8a-13a, *infra*). The opinion of the district court (R. 18) is

reported at 200 F. Supp. 321 and is reprinted in Appendix A (pp. 1a-7a, *infra*).

JURISDICTION

The judgment of the court of appeals (R. 46) was entered on October 21, 1963. A timely-filed petition for rehearing was denied on December 2, 1963 (R. 73; p. 14a, *infra*). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether the Commissioner of Internal Revenue may compel a taxpayer, who has properly elected to employ the "last-in-first-out" (LIFO) method of inventory valuation as established by the Internal Revenue Code, to "unfreeze" the original inventory cost and to increase such cost by the amount of taxes subsequently imposed on units of inventory—despite the statutory command that original inventory is to be set and remain "at cost" when the LIFO method of inventory valuation is used.

STATUTES INVOLVED

The statute principally involved is Section 22(d) of the Internal Revenue Code of 1939. Its provisions are carried forward in substantially identical form as Section 472 of the Internal Revenue Code of 1954. Section 22(d) provided in pertinent part:

> "(d) (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):
>
> "(A) Inventory them at cost;

"(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

"(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

* * * * *

"(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

"(4) In determining income for the taxable year preceding the taxable year for which such method is first used, the closing inventory of such preceding year of the goods specified in such application shall be at cost."

Other relevant statutes, including Section 472 of the 1954 Code, and the relevant Treasury Regulations thereunder are set out in Appendix E hereto (pp. 19a-28a, *infra*).

STATEMENT

Petitioner is a manufacturer of liqueurs and other alcoholic beverages. Beginning in 1942 and continuing to the present time, petitioner, as permitted by the Internal Revenue Code, consistently used the "last-in-first-out" (LIFO) method of valuing its inventory of finished products and goods in process. The LIFO method is based on the assumption that a business

using inventories physically disposes of the inventoried units in the reverse order of their acquisition. The method was authorized by Congress for use by certain selected taxpayers in 1938, Revenue Act of 1938, ch. 289, § 22(d), 52 Stat. 459, and for taxpayers generally in 1939, Revenue Act of 1939, ch. 247, § 219 (a), 53 Stat. 877, amending Internal Revenue Code of 1939, ch. 2, § 22(d), 53 Stat. 11, when Section 22(d) was added to the Internal Revenue Code of 1939. The authorization continues unchanged in Section 472 of the Internal Revenue Code of 1954.

The purpose of the LIFO method is to match current expenses with current receipts so as to protect the taxpayer against being taxed on paper profits and to protect the Government against the avoidance of tax on paper losses that are attributable to inflation or deflation of the prices of replacement inventory items. During a period of changing prices such paper profits or losses can result in the following manner: For most producing and selling businesses the major business cost deducted from gross income to arrive at taxable income is the cost of goods sold. This cost is computed by adding to the value of inventory on the first day of the year (opening inventory) the value of goods purchased during the year and expenditures directly attributable to such goods and deducting from the resulting gross cost of goods purchased the value of the inventory at the close of the year (closing inventory). The larger the value of the closing inventory, the lower the cost of goods sold and consequently the greater the taxable income. In a period of rising prices the value of the closing inventory will be larger if it is assumed that the taxpayer sold his goods in the order of their acquisition, leaving the

higher-priced, most recent acquisitions in his year-end inventory. But under LIFO the value of the year-end inventory will be lower because of the assumption that it contains the lower-priced, earliest acquisitions. Conversely, when replacement prices are falling, LIFO prevents a taxpayer from taking paper losses by preventing an inordinately low closing inventory, which in turn would cause an economic overstatement of cost of goods sold.

Petitioner determined in 1942 to adopt the LIFO method. The facts, stipulated in the district court, show without dispute that petitioner was authorized by the Commissioner to adopt this method and qualified to adopt it and to employ it subsequently.[1] Petitioner calculated its opening inventory as of October 1, 1943, the beginning of the first fiscal year in which it used LIFO. As required by the revenue laws the opening inventory was valued at cost, which included a federal excise tax of $4 per proof gallon then being levied on distilled spirits.

Effective November 1, 1942, one month after petitioner adopted the LIFO method, the excise tax on distilled spirits was increased by $2 per proof gallon; on April 1, 1944, that tax was increased by an additional $3, and on November 1, 1951, by yet an additional $1.50. In general, the excise tax on distilled spirits is payable when the spirits are produced or withdrawn from bond. On each occasion that the excise tax was increased the Congress imposed a so-called floor stocks tax, in the amount of the excise tax increase, on distilled spirits that had been withdrawn from bond and were being held for sale or other dis-

[1] The stipulation is at R. 12-17. The textual portion thereof is reproduced as Appendix D to this petition, pp. 15a-18a, *infra*.

position.[2] The purpose of the floor stocks tax was, of course, to place distilled spirits withdrawn from bond but not yet sold for consumption on a parity with spirits still in bond or not yet produced.

Petitioner consistently treated its excise taxes for income tax purposes by including in the year of an increase the amount of both any such increase and any corresponding floor stocks taxes as costs of selling goods. If the closing inventory of a year included units acquired during the year, their valuation at cost included the amount of excise tax attributable to them, just as the units in the opening LIFO inventory were valued at a cost that included the excise tax that had been paid on them. Units carried forward to year-end inventory from the opening inventory of the year, however, were not revalued to reflect floor stocks taxes paid on them. On audit the Commissioner of Internal Revenue took the position that petitioner was required to make that revaluation in each year in which floor stocks taxes were paid. This recomputation of the historical LIFO cost would, of course, have the effect in each year of increasing the value of closing inventory, reducing the cost of goods sold and thus increasing taxable income. Proceeding on that basis the Commissioner assessed additional income and excess profits taxes against the petitioner for its fiscal years ending in 1943, 1944 and 1951.[3] Petitioner paid the assessments

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[2] The statutes raising the excise tax and imposing the floor stocks taxes are: Revenue Act of 1942, ch. 619, §§ 602(a), 602(d), 56 Stat. 970, 971; Revenue Act of 1943, ch. 63, §§ 302(a), 308(a), 58 Stat. 61, 67; Revenue Act of 1951, ch. 521, §§ 451(a), 451(e), 65 Stat. 524, 525. See Appendix E, pp. 21a-23a, *infra*.

[3] The deficiency for 1951 resulted from a decrease in the amount of the loss carryback from 1952. This latter was the year during which the Commissioner's adjustment with respect to the 1951 floor stock tax had its impact.

and, having failed to effect an administrative settlement, sued for a refund. The district court, concluding that the effect of what the Commissioner proposed doing "would be to require the taxpayer to abandon LIFO accounting as to the floor stocks taxes," gave judgment for petitioner. On appeal this judgment was reversed by the United States Court of Appeals for the Sixth Circuit and the petitioner's complaint was ordered dismissed.

REASONS FOR GRANTING THE WRIT

The court of appeals has decided an original question of substantial importance in the administration of the federal income tax law, a question that has not been but should be settled by this Court. That question is whether a taxpayer who elects and qualifies to use the LIFO method of inventory valuation can be required to revalue basic layer and accretion layer units in its year-end inventory by the amount of payments made currently for inventory maintenance expenses, specifically for personal property taxes in the form of a floor stocks tax.[4] The decision of the court of appeals that a taxpayer may be so required is plainly wrong, contrary not only to the very theory of LIFO accounting but also to the plain mandate of the Internal Revenue Code.

The decision below permits continual adjustments with respect to a vast range of expenses in LIFO in-

[4] For simplicity the matter was argued and treated in the courts below as involving a revaluation only of the petitioner's basic layer LIFO inventory. In fact, there was also revaluation of accretion layer goods (that is, goods added to the original inventory in later years) to reflect floor stocks taxes levied after their acquisition. The principle at issue is identical in its application to these additional "layers" of LIFO inventory.

ventories.[5] The broad reach of the decision of the court of appeals was made quite explicit: "If . . . costs [subsequently incurred] are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether Lifo, Fifo or any other method is used." In addition to the floor stocks taxes that are involved here, this holding obviously applies to State and local personal property and similar taxes, storage expenses, insurance and, in sum, any other costs that can be attributed to the goods on hand."

At the outset it should be noted that the decision below is indisputably contrary to the unanimous view of accounting experts who have written on the LIFO method. These authorities, without dissent, state that —once priced for inventory purposes—goods that remain in inventory pursuant to the LIFO method of valuation do so at the historical price originally fixed for them, which cannot be changed. That precept, indeed, is at the heart of the LIFO method. See, *e.g.*, BUTTERS, EFFECT OF TAXATION: INVENTORY ACCOUNTING AND POLICIES 75, 79, 83 (1949); AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN NO. 43, at 28-29, 34 (1953); Blough (ed.), *Current Accounting and Auditing Problems*, 93 J. ACCOUNTANCY 600-601 (May 1952); DOMINION ASS'N OF CHARTERED ACCOUNTANTS, CANADIAN RESEARCH BUL.

[5] Even if the decision of the court of appeals is confined solely to floor stocks taxes, such expenses, as can be seen from § 4226 of the Internal Revenue Code of 1954, are a common occurrence for a very large number of varied taxpayers. The adjustments which would be required by a uniform application of the holding of the court of appeals would affect thousands of taxpayers and would doubtless involve many millions of dollars.

LETIN No. 5, in 91 J. ACCOUNTANCY 141, 142 (January 1951); Lasser in ENCYCLOPEDIA OF TAX PROCEDURE 290-91 (1956); Peloubet, *Has Lifo Fallen?*, 85 J. ACCOUNTANCY 298 (April 1948); Tannenbaum, *The Lifo Method*, 25 TAXES 492 (1947); Welsch, *Lifo Method of Inventory Valuation*, 30 TAXES 343, 344 (1952).

Most importantly, the decision of the court of appeals on this seminal question is contrary to the governing statute; Section 22(d) of the Internal Revenue Code of 1939, re-enacted and in effect without substantive change as Section 472 of the current Code. By Section 22(d)(1) taxpayers were authorized, upon application, to inventory goods specified in such application in the following manner:

> (a) inventory the goods at cost;
>
> (b) treat the goods remaining on hand at the end of a taxable year as, *first*, the goods in the opening inventory of that year in the order of their acquisition to the extent thereof and, *second*, the goods acquired during the taxable year, and
>
> (c) treat the goods included in the opening inventory of the taxable year in which the LIFO method is first used as having been acquired at the same time and determine their unit cost by averaging their aggregate cost.

Section 22(d) of the 1939 Code was, and Section 472 of the 1954 Code is a complete, self-contained statutory sanction for a particular method of inventory

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[6] Taxpayers had options in determining what units acquired during the taxable year should be treated as included in year-end inventory. Treas. Reg. 118, § 39.22(d)-2(d); Treas. Reg. 111, § 29.22(d)-2(d); Treas. Reg. 103, § 19.22(d)-2(d). Since the relevant portions of Parts 103 (1939-1941) and 118 (1952-1953) of the Treasury Regulations are the same in all significant respects as Part 111, only the latter will be cited hereafter.

valuation. Section 22(c) of the 1939 Code provided, as had its predecessor statutes for many years,[7] and as Section 471 of the 1954 Code still does, that whenever the Commissioner found the use of inventories necessary to determine clearly the income of a taxpayer, inventories should be employed on a basis prescribed by the Commissioner. In pointed contrast, Section 22(d)(1) expressly provided that a taxpayer could use the LIFO method "whether or not such method has been prescribed under" Section 22(c). The Commissioner was thus divested of any power he might have had under Section 22(c) to deny the right to use the LIFO method to any taxpayer that otherwise qualified.

Petitioner followed the statute and regulations precisely and consistently in changing to and employing the LIFO method over the years in question. When it converted to LIFO beginning with its 1942-43 fiscal year it established its opening inventory by averaging the cost of the units on hand. Included in the opening inventory cost was the $4 federal excise tax on distilled spirits then applicable.[8] Treatment of excise taxes on goods as an element of their cost of acquisition in valuing them for inventory was and is an acceptable practice.[8] The practice had been followed by petitioner in previous years in which it had used the customary first-in-first-out (FIFO) inventory valua-

[7] See Revenue Act of 1938, ch. 289, § 22(c), 52 Stat. 459; Revenue Act of 1936, ch. 690, § 22(c), 49 Stat. 1658; Revenue Act of 1934, ch. 277, § 22(c), 48 Stat. 688; Revenue Act of 1932, ch. 209, § 22(c), 47 Stat. 179; Revenue Act of 1928, ch. 852, § 22(c), 45 Stat. 799; Revenue Act of 1926, ch. 27, § 205, 44 Stat. 16; Revenue Act of 1924, ch. 234, § 205, 43 Stat. 260; Revenue Act of 1921, ch. 136, § 203, 42 Stat. 231; Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1060 (1919).

[8] The then applicable regulation was Treas. Reg. 111, § 29.23(c)-2.

tion method.[8] This consistent practice continued through all the years in question. Excise taxes paid, including in years in which the excise tax on distilled spirits was increased the amount of the increase, were of course reflected in the cost of any new replacement units that entered the closing inventory of that year. But, in obedience to the statute, to the theory of LIFO accounting and to the taxpayer's consisent prior practice, inventory units were not revalued to reflect floor stocks taxes imposed after their acquisition. Nor were they revalued to reflect personal property and similar taxes assessed and collected on goods on hand; nor to reflect storage expenses; nor insurance costs; nor any current cost of maintaining goods in inventory that was included—like the floor stocks tax—in the current cost of goods sold and not charged to inventory.

The district court correctly reasoned that Section 22(d) did not permit adjustments to the value of units of LIFO inventory for any such subsequently incurred costs. The district court pointed out that, even were one to resort to Section 22(c) for a guide to the meaning of the statutory word "cost," the regulations under Section 22(c) defined cost, in the case of goods on hand at the beginning of the taxable year, as the inventory price of such goods.[9] The court concluded:

> "[T]he 'cost' of 'those included in the opening inventory' is taken as the 'inventory price.' This, in turn, could only be the 'price' assigned to the goods for the preceding closing inventory, which was, in turn, calculated in the same way. This successive reference back is the heart of the LIFO method. Since 'cost' for each year is the same as

[8] The applicable regulation required that the actual aggregate cost of the goods making up the initial LIFO inventory "be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year." Treas. Reg. 111, § 29.22(d)-2(c).

[9] Treas. Reg. 111, § 29.22(c)-3(l).

> 'inventory price,' which, in turn, is merely 'cost' from the preceding year, it necessarily implies that 'cost' (for goods considered as continuously in inventory) is constant once the goods have entered the inventory. We thus find the price of the goods to be the price assigned to them as cost of acquisition at the time acquired or the time when LIFO was first instituted." (App. p. 4a)

The decision of the court of appeals overturning this conclusion of the district court cannot be sustained on any narrow ground that would leave undisturbed the LIFO accounting of other taxpayers for expenses other than floor stocks taxes. The court of appeals did say that the Commissioner was merely requiring petitioner to be consistent. The inconsistency the court thought it saw in petitioner's own tax accounting lay in the fact that the original LIFO valuation included excise taxes and floor stocks taxes previously paid on the goods in question,[11] while, as we have

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[11] The stipulation on which this case was tried stated that "as of October 1, 1942, when plaintiff determined opening inventory at cost, the excise tax on distilled spirits, as provided by the Internal Revenue Code of 1939, was $4.00 per proof gallon, and this amount was included by plaintiff in determining its cost of finished products and distilled spirits, exclusive of distilled spirits in bond, as comprising its opening inventory as of October 1, 1942." (App. p. 16a) The excise tax on distilled spirits had been increased from $2 to $4 in two stages, on July 1, 1940, and October 1, 1941. Revenue Act of 1940, ch. 419, § 213(a), 54 Stat. 524; Revenue Act of 1941, ch. 412, § 533(a), 55 Stat. 708. Both times that the excise tax was increased a floor stocks tax equal to the increase was imposed. Revenue Act of 1940, ch. 419, § 213(a), 54 Stat. 524; Revenue Act of 1941, ch. 412, § 533(d), 55 Stat. 708. The stipulation does not state whether there were goods in the October 1, 1942, inventory on which not the full amount of the $4 excise tax but a smaller excise tax and the equalizing floor stocks tax had been paid. As we shall show in the text, the point is of no consequence despite the emphasis laid by the court of appeals in its opinion and in its order denying rehearing on the asserted fact that floor stocks taxes were included in the cost of goods in the 1942 opening inventory.

noted, subsequent floor stocks taxes were not added to the inventory price of units already in inventory at the time they were imposed. There is no inconsistency. A going business converting to the LIFO method of inventory valuation must construct an inventory with which to open the first taxable year in which the method is used. The statute states generally how this is to be done. The statute requires inventorying at cost, and it is necessary to include as elements of the "cost" of acquiring the goods and placing them in the new LIFO inventory all expenses theretofore incurred that are directly attributable to the goods. Those expenses certainly would comprehend floor stocks taxes laid on the goods before they were placed in the opening inventory. Thereafter, if additional units are placed in inventory, creating new "layers" of LIFO inventory, they are assigned a value equal to the cost of their acquisition, which may or may not include the amount of any floor stocks tax imposed during the taxable year, depending on when they were acquired. But once goods are in inventory their value is frozen. Storage costs, state and local personal property taxes, floor stocks taxes and other maintenance expenses in subsequent years are treated as expenses of manufacturing and selling goods, not as adjustments to inventory prices.

There is a similar lack of substance to a suggestion made below by the Government that floor stocks taxes warrant special treatment because they are somehow additions to excise taxes long since paid. It is quite true that the purpose of the floor stocks taxes is to equalize the tax burden on all beverages not yet sold. But this does not mean that they appropriately can be considered as additions to a tax that may have been

paid many years before—and on goods that only because of the LIFO fiction are considered still to be on hand. The Government could better argue that a lump-sum retroactive wage increase covering a past taxable year should be added to the inventory price of finished products into which the labor in question entered. The readily admitted fact that floor stocks taxes are designed by the Congress to equalize prices among competitors on goods physically on hand certainly does not suggest that the design was also to amend Section 22(d) to require that the prices of goods only fictionally on hand be adjusted between the taxpayer and the Commissioner. The truth, as demonstrated above, is that such a taxpayer-Commissioner price adjustment would violate the most basic pre-supposition of LIFO inventory valuation—that the historical LIFO cost (based originally on the several expenditures necessary to acquire the basic layer goods and place them in the inventory), once properly established, is frozen and is not to be disturbed.

The effect of the adjustments exacted by the Commissioner and sanctioned by the court of appeals is that—at least with respect to floor stocks taxes and, if this new adjustment is to be consistently applied, with respect to all other inventory maintenance costs—all taxpayers that formerly used the LIFO method are now to be placed on a current-cost method of inventory accounting. For illustration, let it be assumed that a certain number of units had remained undisturbed in the basic layer of LIFO inventory from 1942 through 1952 with a 1942 unit cost of $2, exclusive of the prevailing excise and floor stocks taxes of $4. Under the LIFO method, as known until the court of appeals wrote, the 1952 opening inventory

unit price would be $6. But under the new view now advanced, the 1953 opening inventory unit price is to be $12.50. No units are to be carried at a value lower than the most recent per unit cost of all excise and floor stocks taxes. This is not LIFO inventorying. It is even more extreme than FIFO accounting, which at least requires unit turn-over before the value of inventory units is increased to current prices.

The decision below unquestionably poses the question to which the court below gave an affirmative answer—whether "costs subsequently incurred . . . properly attributable to the goods on hand . . . ought to be reflected in the closing inventory. . . ." The court of appeals' answer, if allowed to be the final answer, would have a drastic effect; an effect, indeed, that would totally frustrate the Congressional purpose in authorizing taxpayer use of the LIFO method. Certainly, the question thus raised cannot be dismissed as one that is not important in the administration of the taxing statutes.

CONCLUSION

For the foregoing reasons the petition for certiorari should be granted.

Respectfully submitted,

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February 1964

APPENDIX A

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

Civil Action No. 16382

MOHAWK LIQUEUR CORPORATION, *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*.

Opinion

Mohawk Liqueur Corporation, herein referred to as taxpayer, paid certain assessed income and excess profits tax deficiencies and now sues for a refund. The facts have been stipulated. Taxpayer manufactures and sells various liqueurs, wines, and distilled liquors and thus was liable for, and paid, certain federal taxes (floor stocks taxes) on its stocks of distilled spirits. The issue which is now before the court is whether the cost originally assigned to the basic "last-in, first-out" (LIFO) inventory should be adjusted for the floor stocks taxes subsequently levied, as the Government contends, or whether the taxes should be considered current expenses of the years in which they were assessed and paid, the view contended for by the taxpayer.

A necessary step in the calculation of taxable income for any period is the determination of the "cost" of the closing inventory. LIFO assumes that the articles sold during the taxable year were those most recently purchased so that those remaining in inventory are assumed to be the first items purchased. Thus, the "cost" of the closing inventory is ordinarily determined by the cost of acquisition of the first items purchased. The object of the LIFO fiction is to match current expenses more closely to current income, since the cost of the last item of inventory is

usually closer to the replacement cost of the item than is the price of the first bought. In theory, this method makes the income statement of a going concern more accurate although it results, in time of rising prices, in an increasingly undervalued inventory.

Taxpayer elected the LIFO method of inventorying its distilled spirits and finished products on October 1, 1942, as allowed by Section 22(d) of the Internal Revenue Code of 1939,[1] (re-enacted without important changes as Section 672 [sic], Internal Revenue Code of 1954, 26 U.S.C. 472). Taxpayer subsequently filed its returns on that basis. The validity of its election is not disputed.

In its first LIFO opening inventory, taken as of October 1, 1942, taxpayer included the $4 per gallon excise tax[2]

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[1] Section 22(d)(1). A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

* * * * * *

(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

[2] Revenue Act of 1941, Sec. 533, 55 Stat. 487 (1941), amending Internal Revenue Code of 1939, Sec. 2800(a) (now 26 U.S.C. § 5061(a)).

which it had previously paid as part of the cost of the spirits in its inventory. Effective November 1, 1942, Congress increased this tax to $6 per gallon.[3] As the excise tax attached to the spirits only on distillation or removal from bond; this change did not affect taxpayer's basic LIFO inventory, which consisted only of spirits already distilled or removed from bond, and hence, is not in issue. However, Congress, in the same act, effective November 1, 1942, enacted a floor stocks tax of $2 per gallon payable on all distilled spirits held for use in manufacturing or for sale on which the previous $4 per gallon excise tax had been paid.[4] In 1944, the excise tax was raised to $9 per gallon,[5] and a $3 per gallon floor stocks tax was enacted.[6] In 1951, the excise tax was raised to $10.50 per gallon,[7] and a $1.50 per gallon floor stocks tax was enacted.[8]

Thus, the spirits, which, under LIFO theory were assumed to have been continuously in the taxpayer's inventory, were subject to four separate excise taxes. The first was the $4 per gallon excise tax which had attached before taxpayer changed to LIFO. The second tax was the $2 per gallon floor stocks tax which attached to them on November 1, 1942. The third was the $3 per gallon floor stocks tax which attached on March 1, 1944. The fourth was the $1.50 per gallon floor stocks tax which attached November 1, 1951. Each of those four taxes was paid by the taxpayer. The Government does not dispute the correctness of taxpayer's treatment of the original $4 per gallon tax as part of the cost of the LIFO opening inventory. The

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[3] Revenue Act of 1942, Sec. 602(a), 56 Stat. 798 (1942).

[4] Internal Revenue Code of 1939, Sec. 2800(j).

[5] Revenue Act of 1943, Sec. 302(a), 58 Stat. 21 (1944).

[6] Internal Revenue Code of 1939, Sec. 2880(k) [sic].

[7] Revenue Act of 1951, Sec. 451(a), 65 Stat. 452 (1951).

[8] Internal Revenue Code of 1939, Sec. 2800(l).

issue thus narrows to the question of the proper treatment of the three floor stocks taxes.

While Section 22(d) is by no means crystal clear, a careful reading of its language and of the pertinent treasury regulations supports the taxpayer's position. Section 22(d) requires the goods to be inventoried at "cost" and requires that the taxpayer "treat those remaining on hand at the close of the taxable year as being: first, those included in the opening inventory of the taxable year . . ." "Cost" is defined in Treasury Regulations 111 Par. 29.22 (c)-3 as follows: "Cost means: (1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods." Hence, the "cost" of "those included in the opening inventory" is taken as the "inventory price." This, in turn, could only be the "price" assigned to the goods for the preceding closing inventory, which was, in turn, calculated in the same way. This successive reference back is the heart of the LIFO method. Since "cost" for each year is the same as "inventory price", which, in turn, is merely "cost" from the preceding year, it necessarily implies that "cost" (for goods considered as continuously in inventory) is constant once the goods have entered the inventory. We thus find the price of the goods to be the price assigned to them as cost of acquisition at the time acquired, or the time when LIFO was first instituted. Rebate [sic, probably should be "Hence,"] "cost" could not include the subsequently enacted floor stocks taxes.

The legislative history of Section 22(d), although meager, supports this interpretation. The first version of this section, which appeared as a Senate floor amendment to the Revenue Act of 1938, used the words "last-in, first-out." It applied to most taxpayers with fungible inventories and read as follows:

> "The cost of goods sold during any taxable year beginning after December 31, 1938, may be computed on the last-in, first-out basis if such basis conforms

as nearly as may be to the best accounting practice in the trade or business, . . .'' (83 Cong. Rec. 5042).

The only discussion of the amendment was by its supporters, who indicated that they had in mind authorizing the usual and ordinary LIFO method, involving items whose cost would be taken as fixed once they were placed in inventory. 83 Cong. Rec. 5042ff.

When the amendment came out of conference, it no longer contained the words "last-in, first-out," and it was limited to certain industries. It prescribed the method of taking inventory in terms similar to those in the present law. The managers in conference on the part of the Senate indicated that, except for the limited scope of application, the intent of the conferees was to enact the Senate floor amendment. 83 Cong. Rec. 6440ff.

The Revenue Act of 1939 made the LIFO section applicable to all taxpayers with fungible inventories and phrased it in virtually its present form. The committee report accompanying the bill explained that the only purpose of the changes was to make the optional method applicable to more taxpayers. S. Rep. No. 648, 76th Cong., 1st Sess.

This legislative history indicates that Congress intended to allow those taxpayers who could qualify under Section 22(d) to use the LIFO method of inventory evaluation. It also seems clear that Congress assumed that the "cost" of a particular item in inventory, once determined as of some date (usually the date of acquisition), does not change.

The Government's position in this case thus appears to be in conflict with the congressional intent in that the effect of the Government's method would be to require the taxpayer to abandon LIFO accounting as to the floor stocks taxes. The object of LIFO is to allow rising costs of doing business to be set against current income rather than be applied to inventory and recovered at a future time. Yet,

as to the increased inventory replacement cost represented by the floor-stocks taxes, the Government urges that these be added to inventory valuation to be recovered at some time in the future when these items, assumed to be the last sold, are disposed of. This would have the effect of deferring the recovery of these particular costs until taxpayer's inventory is finally liquidated, a result quite the opposite of that intended when Congress permitted the use of LIFO in inventory valuation.

The taxpayers's position here is also well supported by established accounting theory and practice. See Wixon, *Accountant's Handbook*, § 17 (4th ed. 1957). In defining the "cost" of a LIFO inventory, the one time (per item) expenses involved in the acquisition of goods are properly allocable to the cost of the goods. On the other hand, the typical recurring expenses of inventory maintenance, such as state and municipal personal property taxes, insurance and warehousing, are unquestionably chargeable to the day-to-day expenses of running the business. The floor stocks taxes here in question are akin to these expenses of maintaining an inventory, in that they are merely a cost necessary to its continued existence.

There remain two points urged by the Government which need a word of discussion. The first is that the Commissioner's action in assessing the deficiency was within Section 22(d)(3), as a regulation to insure that the plaintiff's return "clearly reflects income." However, the Commissioner has issued no regulation which supports the Government's position in this action. The only regulations pertinent to the case merely restate the Senate Finance Committee's explanation of the section. In fact, the regulations tend to support the plaintiff's position, as they, too, are written with the implicit assumption that historic cost, once established in accordance with the statute, does not change. Treas. Reg. 111, § 29.22(d).

In any event, if, as legislative history and the wording of the statute indicate, Congress intended to allow the use of LIFO, then it would seem to be beyond the authority of the Commissioner to issue a regulation requiring a taxpayer who has properly elected LIFO to use instead a system that is LIFO only in part and defers recovery of those expenditures which the Commissioner deems appropriate to so require.

The Government also directs my attention to the case of *Lucas* [sic] v. *Structural Steel Co.*, 281 U.S. 264 (1930), in which the Supreme Court upheld the Commissioner's action in ruling the "base stock" system of inventory evaluation invalid as not clearly reflecting income. That case would indeed be apposite if Congress had not, in the meantime, passed the LIFO provision of the Internal Revenue Code. To the extent that that case is authority for denying to taxpayers the use of LIFO, it has obviously been overruled by Congress, as regards taxpayers who come within the scope of Section 22(d).

The floor stocks taxes are excludable from the cost of the LIFO inventory. Judgment for the plaintiff may be entered.

THEODORE LEVIN
Chief United States District Judge

Dated: Detroit, Michigan
December 28, 1961

APPENDIX B

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee,*

-v-

UNITED STATES OF AMERICA, *Defendant-Appellant.*

ON APPEAL from the United States District Court for the Eastern District of Michigan.

Decided October 21, 1963.

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

WEICK, Circuit Judge. The action in the District Court was to recover income and excess profits taxes alleged to have been overpaid for the fiscal years ended September 30, 1943, September 30, 1944 and June 30, 1951 in the amount of $83,691.45 including accrued interest.

The legal question involved was whether taxpayer, a manufacturer of alcoholic beverages, in computing its income, may deduct, as an ordinary and necessary business expense, floor stocks taxes imposed on its distilled spirits on hand instead of adding such taxes to the cost of its inventory in accordance with its previous practice.

The District Court ruled in favor of taxpayer permitting the floor stocks taxes to be expensed and the Government appealed.

Taxpayer, with the approval of the Commissioner of Internal Revenue, had elected to inventory its distilled spirits and finished products on the Lifo (last-in-first-out) method. Its original inventory was computed at cost as of

October 1, 1942, the commencement of its fiscal year. At that time the excise tax on distilled spirits was $4.00 per proof gallon which taxpayer had paid and included in its inventory as part of the cost of its distilled spirits.

Effective November 1, 1942 Congress increased the excise tax on distilled spirits from $4.00 per proof gallon to $6.00 per proof gallon. This tax was imposed on distilled spirits on distillation or removal from bond on which no previous excise tax had been paid. In order to reach distilled spirits on hand which had been subject to the lower excise tax, Congress enacted a floor stocks tax of $2.00 per proof gallon. This applied to spirits in taxpayer's opening inventory. The purpose of the floor stocks tax was to equalize the tax on all distilled spirits so that the increased tax would be included in the price of all spirits sold after the date of the tax increase.

In 1944, the excise tax on distilled spirits was increased by the amount of $3.00 per proof gallon and again in 1951 by $1.50 per proof gallon. In said years floor stocks taxes were also imposed in the respective amounts of $3.00 and $1.50 per proof gallon on stocks of distilled spirits on hand. Floor stocks taxes are included in the general classification of excise taxes. The parties to this case in their briefs, however, used the term "floor stocks taxes" when considering them and "excise taxes" when referring to taxes other than floor stocks taxes.

Taxpayer's Lifo beginning inventory in 1942 contained both excise taxes on distilled spirits and floor stocks taxes which had been included as part of the cost of goods on hand. The floor stocks taxes imposed thereafter in 1942, 1944 and 1951 were paid by taxpayer and the amounts thereof were not added to the ending inventories in those years, but treated as ordinary business expenses. The Commissioner disallowed the deductions and added the floor stocks taxes to taxpayer's closing inventory in the applicable tax years.

Excise taxes imposed in 1942 and thereafter were treated by taxpayer as a cost to be included in inventory produced or obtained after the effective date of such taxes.

The tax consequences of taxpayer's treatment of the floor stocks taxes were that it had a deduction from income for the full amount thereof and by not adding the amount of such taxes to its closing inventory for the year on which the taxes were increased, the inventory did not reflect the tax increase. The effect of this was to increase taxpayer's cost of goods sold thereby decreasing its profits subject to income taxes.

It is the contention of taxpayer that the beginning inventory in the Lifo method must be fixed at cost and once established is frozen and cannot be changed.[1] Cost is de-

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[1] "(d) *Method of inventorying goods.* (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method."

* * * * *

"(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

"(4) In determining income for the taxable year preceding the taxable year for which such method is first used, the closing inventory of such preceding year of the goods specified in such application shall be at cost." [Section 22(d), Internal Revenue Code of 1939; 26 U.S.C.; 1952 ed., Section 22(d)]

fined in the regulations.[2] Taxpayer contends that the action of the Commissioner in adding the floor stocks taxes to its closing inventory as part of the cost of goods was unauthorized.

The taxes in this case comprise a large portion of the cost of the distilled spirits and of their selling price. The floor stocks taxes were imposed on the amount of distilled spirits on hand and relate directly to them.

The general purpose of the enactment of the statute providing for the Lifo method was to afford relief against inventory profits in a rising market. *R. H. Macy & Co.* v. *United States*, 255 F. 2d 884 (CA 2). We find nothing in the legislative history reflecting on the issue here involved.

As we see it, we are not concerned with whatever right the taxpayer had initially to expense excise taxes or add them to its inventory.

Section 23 of the Internal Revenue Code of 1939 authorized their deduction as ordinary and necessary business expenses.

The regulations permit the inclusion of excise taxes as part of the cost of an inventory. Section 29.23 (C)-2 of Treasury Regulations 111.

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[2] "SEC. 29.22(c)-3. *Inventories at Cost.*—Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods."

* * * * *

"(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit."

Accounting principles recognize the addition of excise taxes to the cost of inventory. Patton & Dixon, Essentials of Accounting (1958), p. 253; Wixon, Accountants Handbook, pp. 5, 6, 33-35.

In 2 Mertens, Law of Federal Income Taxation (Rev. ed. 1961) § 16.17, the author states: "Customs duties and excise taxes may at the option of the taxpayer be deducted from gross income as business expenses or added to the cost of the goods.

Specifically, our problem is whether taxpayer, having included excise and floor stocks taxes in his opening Lifo inventory, may depart from this practice and expense the floor stocks taxes imposed in the subsequent years.

Consistency is required in inventory practices from year to year. Once a taxpayer has treated floor stocks taxes as part of the cost of merchandise purchased he may not deviate from this practice in subsequent years. *Guy T. Gibson, Inc.* v. *Commissioner*, 46 B.T.A. 1015; *Bobrow Bros., Inc.* v. *Commissioner*, 135 F. 2d 209 (CA 3); Treasury Reg. 29.22 (C 1-2) promulgated under Internal Revenue Code of 1939; 2 Mertens, Law of Federal Income Taxes § 16.06.

Conceding that under the Lifo method the costs of a beginning inventory are frozen, we do not see how this affects the manner in which costs subsequently incurred should be treated in the closing inventory. If such costs are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether Lifo, Fifo, or any other method is used. Under Lifo, however, the cost of the beginning inventory for the subsequent year must be taken from the closing inventory of the previous year.

The Commissioner is not without power to compel consistency in inventory practices. We think Section 22(c) of the Internal Revenue Code of 1939 confers power upon

him to conform any inventory to the best accounting practice which most clearly reflects income.

In our judgment, it was not unreasonable for the Commissioner to do so in the present case.

The judgment of the District Court is reversed and the cause is remanded with instructions to dismiss the complaint.

APPENDIX C

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee*,

-vs-

UNITED STATES OF AMERICA, *Defendant-Appellant*.

Order

(Filed December 2, 1963)

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

In its petition for rehearing, taxpayer contends, inter alia, that since floor stocks taxes were not included in its beginning inventory in 1942, we erred in holding that the floor stocks taxes should be treated as part of the cost of the closing inventories for the applicable tax years.

This proposition is not only contrary to the briefs and record herein, but also in reply to this Court's written Interrogatory submitted to the parties, viz: "Whether it is agreed that the cost of the opening inventory on October 1, 1942, included *both excise and floor stocks taxes* paid on distilled spirits on hand?" Appellee's answer thereto was as follows: "Appellee agrees that such costs were so reflected in the cost of its inventory as determined October 1, 1942."

Taxpayer was not required to include its excise and floor stocks taxes as part of its opening inventory, but as stated in our opinion: "Once a taxpayer has treated floor stocks taxes as part of the cost of merchandise purchased he may not deviate from this practice in subsequent years."

The petition for rehearing is denied.

PAUL C. WEICK
United States Circuit Judge

APPENDIX D

Stipulation of Question Involved and Facts Years Involved in Controversy

(Filed December 17, 1958)

Plaintiff's claim is predicated upon alleged over-payment of income taxes and excess profit taxes, and assessed interest thereon, as follows:

		Taxes	Assessed Interest
Fiscal year ending Sept. 30, 1943:			
Excess profits tax of		$70,648.35	$21,427.30
Fiscal year ending Sept. 30, 1944:			
Excess profits tax of		10,010.41	1,206.81
Fiscal year ending Sept. 30, 1945:			
Income tax of		(5,740.30)	
Excess profits tax of		816.41	
Fiscal year ending Sept. 30, 1946:			
Income tax (deficiency) of	12,318.91		
Excess profits tax (deficiency) of	7,878.64		
		(20,197.55)	
Fiscal year ending June 30, 1951:			
Income tax of		5,520.02	
		$61,057.34	$22,634.11
		22,634.11	
	Total	$83,691.45	

Taxpayer's fiscal year was changed to terminate June 30 on July 1, 1950.

STIPULATION OR NATURE OF CONTROVERSY OR QUESTION INVOLVED

It is Hereby Stipulated and Agreed that taxpayer kept its books under a method of inventorying its finished products and distilled spirits (exclusive of excise tax on

distilled spirits in bond) on the Lifo basis, pursuant to** Section 22(d)(1) (a) (b) and (c) of the Internal Revenue Code of 1939, as amended. Revenue Act of 1939, 26 U.S.C. 219.

The dispute involved arises over the manner in which the taxpayer shall compute its inventory by reason of the increase of taxes upon distilled spirits by the Revenue Act of 1942, the Revenue Act of 1943, and the Revenue Act of 1951.

As of October 1, 1942, when plaintiff determined its opening inventory at cost, the excise tax on distilled spirits, as provided by the Internal Revenue Code of 1939, was $4.00 per proof gallon, and this amount was included by plaintiff in determining its cost of finished products and distilled spirits, exclusive of distilled spirits in bond, as comprising its opening inventory as of October 1, 1942.

Under the provisions of Sections 601 and 602 (a to d) of the Revenue Act of 1942, and Sections 2800(a)(1) and

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**Inventories:

(a) Amendment to code. Section 22(d) of the Internal Revenue Code (relating to inventories in certain industries) is amended to read as follows:

(d) (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c),) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost:

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

2800 (J), I.R.C., the excise tax on distilled spirits was increased from $4.00 per proof gallon to $6.00 per proof gallon, effective November 1, 1942, and a floor stock tax of $2.00 per proof gallon was imposed on distilled spirits on hand on November 1, 1942.

Under the provisions of Section 308(a) of the Internal Revenue Act of 1943 (Sec. 2800(K) I.R.C., effective April 1, 1944, the excise tax on distilled spirits was increased an additional $3.00 per proof gallon.

Under the provisions of Section 451(c) of the Internal Revenue Act of 1951 (Sec. 2800(1) I.R.C., effective November 1, 1951, the excise tax on distilled spirits was again increased an additional $1.50 per proof gallon.

In each year when the floor stock tax became effective, the additional tax on the distilled spirits then on hand was paid by the plaintiff, and in its Federal income and excess profits tax return filed for each of those years the plaintiff deducted the amount of the floor stock tax paid as a business expense. The deduction was denied by the Commissioner of Internal Revenue, and added to the closing inventories of the plaintiff as a part of the costs of distilled spirits on which the tax was imposed.

The plaintiff contends that to the extent that the portion of the floor stock taxes so paid, which represented the amount of such tax upon its original opening inventory under the Lifo method, the Commissioner was in error.

The effect of these three additional taxes on distilled spirits upon the computation of plaintiff's inventory, as computed by plaintiff, and as adjusted by the Commissioner of Internal Revenue, is set out in the attached schedule marked "Schedule A". [R. 16-17]

STIPULATION OF FACTS

It is Hereby Stipulated and Agreed That:

(1) Plaintiff, Mohawk Liqueur Corporation, is a corporation organized on October 14, 1933, under the laws of the State of Michigan.

(2) This Court has jurisdiction of this cause by virtue of Title 28, U.S.C. 1346, as amended by the Act of July 30, 1934.

(3) Prior to the commencement of this action, the plaintiff had duly filed claims for refund, which included the amounts here in controversy, and more than six months had elapsed before institution of this suit.

(4) Plaintiff's books were kept on a fiscal year basis for the period involved in this action, its fiscal year ending on September 30th of each calendar year, until July 1, 1950, at which time the fiscal year was changed so that the fiscal period terminated in each calendar year thereafter on June 30th.

(5) All issues other than the question here involved have been resloved.

(6) All sums sought to be recovered have been duly assessed, either as income taxes or excess profits taxes, together with assessed interest, and have by the plaintiff been paid

Mohawk Liqueur Corporation

By /s/ Fred R. Walker

United States of America,
Defendant

Fred W. Kaess,
U.S. Attorney,

By /s/ Ealine L. Pfuphat,
Assistant U.S. Attorney.

APPENDIX E

Statutes and Regulations Involved

Internal Revenue Code of 1954:

Sec. 471, Internal Revenue Code of 1954:

> Sec. 471. Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 472, Internal Revenue Code of 1954:

> Sec. 472. (a) Authorization.—A taxpayer may use the method provided in subsection (b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary or his delegate may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.
>
> (b) Method Applicable.—In inventorying goods specified in the application described in subsection (a), the taxpayer shall:
>
> (1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year;
>
> (2) Inventory them at cost; and
>
> (3) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.
>
> (c) Condition.—Subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secre-

tary or his delegate that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—

(1) to shareholders, partners, or other proprietors, or to beneficiaries, or

(2) for credit purposes.

(d) Preceding Closing Inventory.—In determining income for the taxable year preceding the taxable year for which the method described in subsection (b) is first used, the closing inventory of such preceding year of the goods specified in the application referred to in subsection (a) shall be at cost.

(e) Subsequent Inventories.—If a taxpayer having complied with subsection (a), uses the method described in subsection (b) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(1) with the approval of the Secretary or his delegate a change to a different method is authorized; or,

(2) the Secretary or his delegate determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in paragraph (1) of subsection (b) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (A) to shareholders, partners, or other proprietors, or beneficiaries, or (B) for credit purposes; and requires a change to a method different from that prescribed in subsection (b) beginning with such subsequent taxable year or any taxable year thereafter.

If paragraph (1) or (2) of this subsection applies, the change to, and the use of, the different method shall be in accordance with such regulations as the Secretary

or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(f) Cross Reference.—For provisions relating to involuntary liquidation and replacement of LIFO inventories, see section 1321.

Internal Revenue Code of 1939:

Sec. 22(c), Internal Revenue Code of 1939, ch. 1, 53 Stat. 11:

Inventories. Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 22(d)(1), Internal Revenue Code of 1939, ch. 1, 53 Stat. 11, as amended:

(d) Method of inventorying goods. (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

Revenue Act of 1942, ch. 619, Sec. 601, 56 Stat. 970:

Sec. 601. Effective date of this title. This title shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1942, ch. 619, Sec. 602(d), 56 Stat. 971:

> (d) Floor Stocks Tax.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(j) 1942 Floor Stocks Tax.—
>
> "(1) Tax.—Upon all distilled spirits upon which the internal-revenue tax imposed by law has been paid, and which on the effective date of Title VI of the Revenue Act of 1942, are held . . . there shall be levied, assessed, collected, and paid a floor-stocks tax of $2 on each proof-gallon . . . ."

Revenue Act of 1943, ch. 63, Sec. 301, 58 Stat. 60:

> Sec. 301. Effective Date of This Title. This title shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1943, ch. 63, Sec. 308(a), 58 Stat. 67:

> (a) Distilled Spirits.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(k) 1944 Floor Stocks Tax.—
>
> "(1) Tax.—Upon all distilled spirits upon which the internal-revenue tax imposed by law has been paid, and which on the effective date of Title III of the Revenue Act of 1943, are held . . . there shall be levied, assessed, collected, and paid a floor stocks tax of $3 on each proof-gallon . . . ."

Revenue Act of 1951, ch. 521, Sec. 456, 65 Stat. 528:

> Sec. 456. Effective Date of Part V. The amendments made by this part shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1951, ch. 521, Sec. 451(c), 65 Stat. 525:

> (c) Floor Stocks Tax.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(l) 1951 Floor Stocks Tax.—

"(1) Tax.—Upon all distilled spirits upon which the internal revenue tax imposed by law has been paid, and which on the effective date of section 451(a) of the Revenue Act of 1951, are held . . . there shall be levied, assessed, collected, and paid a floor stocks tax of $1.50 on each proof-gallon . . . ."

Treas. Reg. 111, Sec. 29.22(d)-1. Inventories under elective method—

Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22(c), and pursuant to the provisions of sections 29.22(c)-1 to 29.22(c)-8, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22(d). Under this elective inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

First, those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

Second, those acquired during the taxable year.

This elective inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of indentity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year. . . .

Treas. Reg. 111, Sec. 29.22(d)-2. Requirements incident to adoption and use of elective method—

The adoption and use of the elective inventory method is, by section 22(d) and regulations thereunder, made subject to the following requirements:

(1) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied;

(2) The inventory shall be taken at cost regardless of market values;

(3) Goods of the specified type included in the opening inventory of the taxable year for which the method is

first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year with the exception that restoration shall be made with respect to any write-down to market values resulting from the pricing of former inventories;

(4) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices, at costs determined as follows:

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 22(d) as having been acquired all at the same time; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the elective inventory method is used by the taxpayer. . . .

* * * * *

Treas. Reg. 111, Sec. 29.22(c)-1, Need of inventories. In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary

in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment; but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see section 29.22(d)-1.)

Treas. Reg. 111, Sec. 29.22(c)-2. Valuation of inventories. Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance

sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22(c) are (a) cost and (b) cost or market, whichever is lower. (For inventories by dealers in securities, see section 29.22(c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22(d) or to animals inventoried under the elective "unit-livestock-price method" authorized by section 29.22(c)-6. Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in section 29.41-2.

Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22(d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual costs of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

Treas. Reg. 111, Sec. 29.22(c)-3. Inventories at cost. Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (a) farmers and raisers of live stock (see section 29.22(c)-6, (b) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see section 29.22(c)-7, and (c) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see section 29.22(c)-8).

APPENDIX F

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee,*

v.

UNITED STATES OF AMERICA, *Defendant-Appellant.*

On Appeal from the United States District Court for the Eastern District of Michigan

Judgment

(Filed October 21, 1963)

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

Appeal from the United States District Court for the Eastern District of Michigan.

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Michigan, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the cause remanded with instructions to dismiss the complaint.

Approved for entry:

s/ PAUL C. WEICK
United States Circuit Judge

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 872

MOHAWK LIQUEUR CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. App. 1a-7a) is reported at 209 F. Supp. 321. The opinion of the Court of Appeals (Pet. App. 8a-13a) is reported at 323 F. 2d 241.

JURISDICTION

The judgment of the Court of Appeals was entered on October 21, 1963 (Pet. App. 29a), and its order denying the taxpayer's petition for rehearing was entered on December 2, 1963 (Pet. App. 14a). The petition for a writ of certiorari was filed on February 28, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the taxpayer, a manufacturer of alcoholic beverages, is required to treat the amount of floor stocks taxes imposed on its stock of distilled spirits on hand as part of the cost of its inventory rather than as a current business expense.

STATUTE AND REGULATIONS INVOLVED

The relevant portions of the Internal Revenue Code of 1939 and applicable regulations are set forth in Appendix E to the petition (Pet. 19a–28a).

STATEMENT

The taxpayer is a manufacturer of various alcoholic beverages who is required to pay the federal tax on spirits distilled, removed from bond, or held for use or sale.[1] As of October 1, 1942, the taxpayer elected to inventory its distilled spirits and finished products on the LIFO (last-in-first-out) method. At that time the excise tax attaching at the time of manufacture of distilled spirits was $4 per proof gallon. In November, 1942, in 1944, and again in 1951 Congress increased this tax until in 1951 it amounted to $10.50 per proof gallon. Each time Congress increased the excise tax on newly distilled spirits (i.e., on spirits on which no previous excise tax had been paid) it also imposed a floor stocks tax in an amount equivalent to the increase in excise tax upon distilled spirits on

[1] Although floor stocks taxes come within the general category of excise taxes, both parties have, for the purpose of clarity, used the term "floor stocks taxes" when dealing with the taxes imposed on inventory on hand, and the term "excise taxes" when referring to other taxes, such as those imposed upon distilled spirits produced, obtained, or withdrawn from bond.

hand and upon which an excise tax previously had been paid at a lower rate. The purpose of the floor stocks tax was to equalize the tax on all distilled spirits, so that a tax at the increased rate would be included in the price of all spirits sold after the date of the tax increase. (Pet. App. 8a–9a.).

The taxpayer's beginning inventory on October 1, 1942, reflected, as part of its cost of goods on hand, both excise taxes and the compensating floor stocks taxes, such as those which had been imposed in 1940 and 1941. The taxpayer treated the excise taxes imposed in 1942 and subsequent years as a cost to be included in inventory produced or obtained after the effective date of such taxes. However, when the taxpayer paid the floor stocks taxes imposed in 1942, 1944, and 1951, it did not add these taxes to its closing inventories in those years but treated them as current business expenses fully deductible in the year paid. The Commissioner disallowed the deductions and added the floor stocks taxes to the taxpayer's closing inventory as part of the cost of its goods on hand for each of the applicable tax years. (Pet. App. 9a–10a.)

The District Court held (Pet. App. 1a–7a) that the floor stocks taxes should be considered as current expenses of the years in which paid. The Court of Appeals reversed (Pet. App. 8a–13a, 14a), holding that these taxes should be added to the cost of the taxpayer's inventory.

ARGUMENT

The decision below is plainly correct for two independent reasons. There is, moreover, no conflict among the courts of appeals, and the decision does

not present any issue of an importance warranting Supreme Court review.

1. As the court of appeals noted,[2] this case has nothing to do with the technicalities of LIFO, FIFO, or any other method of determining what part of the overall costs of an inventory should be attributed to the goods sold in a particular year. The use of inventories in accounting for the income of a business has two functions: first, it requires the capitalization of the costs of the business that are properly attributable to the goods on hand at the close of the taxable year; second, it provides a method of identifying *which* goods—among those on hand at the beginning of the year or acquired during the year—are deemed to have been sold during the year (the costs attributable to which are deductible as part of the cost of goods sold) and which are deemed to remain on hand at the end of the year (the costs attributable to which must be "capitalized" as the cost of closing inventory). It is only the second question—the identification of the goods sold and the goods retained—that it is the function of the LIFO or FIFO assumptions to answer. That question, however, is not in

[2] The court below stated (Pet. 12a):

"Conceding that under the LIFO method the costs of a beginning inventory are frozen, we do not see how this affects the manner in which costs subsequently incurred should be treated in the closing inventory. If such costs are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether LIFO, FIFO, or any other method is used. * * *"

issue in this case, for it is undisputed that much of the whiskey on which the floor stock tax was assessed must be deemed, under the LIFO assumption employed by the taxpayer, to have remained on hand at the close of the year. This case involves, therefore, solely the first question—namely, whether the floor stock taxes paid, admittedly attributable to the whiskey deemed to remain on hand at the end of year, must be capitalized as part of the "cost" of that whiskey or may be treated as a general administrative expense deductible in the year paid regardless of the volume of sales during that year.

It is plain that the floor stock tax involved in this case must be treated as a cost of the inventory and not as a current expense deductible in whole in the year paid. The floor stock tax, like the excise taxes which the taxpayer in fact capitalized as costs of inventory, is directly attributable to the particular goods on hand and was intended by Congress to be recovered by the taxpayer as part of the selling price of those goods. This tax, moreover, constitutes a very large percentage of the cost of the distilled spirits and of the selling price of the finished product (the alcoholic beverage). Finally, this tax, unlike the costs of storage or personal property taxes, is not incurred annually but only on a single occasion. For these reasons, a gross distortion of taxable income would result from treating the floor stock tax as a current expense rather than as an expense to be

recovered by the taxpayer on the sale of the stock of liquor which is taxed. In the year of sale, the taxpayer will presumably recover the amount of the tax in the form of an increased selling price. If, instead, the taxpayer is allowed to deduct the full amount of the tax in the year it is imposed, its income for that year will be distorted by creating a very large expense properly attributable to sales in later years, and its profits in later years will be exaggerated by failure to consider the effect of the tax on the cost of the goods sold in those later years.[3]

2. The Court of Appeals also correctly held that the taxpayer must be consistent in its accounting treatment of its inventory from year to year. (Pet. App 12a–13a.) Section 22(c) of the 1939 Code (Pet. App. 2a) confers broad discretion upon the Commissioner to determine the proper methods of taking inventory and the proper valuation of items of inventory. Section 29.22(c)–2 of Treasury Regulations 111 (1939 Code) provides that: "In order clearly to reflect

[3] There is no basis for the taxpayer's contention that the applicable provisions of the statutes and regulations do not permit adjustments to be made in the value of inventory when the LIFO method is used. The rules governing the use of the LIFO method (set forth in Section 22(d) of the 1939 Code) do not state how an item's cost is to be calculated. The general rules relating to the determination of the cost of inventory (set forth in Section 22(c) of the 1939 Code, and Section 29.22(c)–3 of Treasury Regulations 111) apply to all methods of inventory accounting. There is nothing in these provisions which prescribes a different and more limited meaning for the term "cost" when applied to the LIFO method, or which prohibits the Commissioner from insisting that the closing inventory for a taxable year must reflect costs properly attributable to the goods on hand at that time.

income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations." The taxpayer must be consistent both in the manner in which similar items are valued in any one inventory and in the manner in which the same item of inventory is valued from year to year.[4] The taxpayer in the present case treated both the excise taxes and the floor stocks taxes as part of the cost of its opening inventory as of October 1, 1942, and continued to account for excise taxes imposed upon distilled spirits produced, obtained, or withdrawn from bond in subsequent years as a cost of inventory in those years. Accordingly, the Court of Appeals was correct in holding that the taxpayer should not be permitted to deviate from the methods selected by it in order to deduct as a current expense the full amount of floor stocks taxes imposed in subsequent years.

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[4] See *Bobrow Bros.* v. *Commissioner*, 135 F. 2d 209 (C.A. 3d). See also, 2 Mertens, Law of Federal Income Taxation (1961 Rev.), Sections 16.05, 16.06.

CONCLUSION

For the reasons stated, the taxpayer's petition should be denied.

Respectfully submitted.

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